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IN THE

Supreme Court of the United States

..... TERM 1966

No. ~~1222~~ 1142

In the matter of the Application of
COLONIAL REALTY CORPORATION,

Petitioner,

against

BACHE & CO.,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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212 RE 2—2692

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner prays that a writ of certiorari issue to review the determination by the United States Court of Appeals for the Second Circuit in the above-entitled case dated March 10, 1966.

Citations to Opinions Below

On March 19, 1964, the Honorable Thomas F. Croake, United States District Judge, Southern District of New York, filed a Memorandum Opinion, printed in Appendix A hereto at page 13, dismissing seven claims contained in the Complaint herein, upon the ground that they involve

no Federal question, but sustaining nine other claims, which rested upon diversity of citizenship and amount, and directing a hearing in respect of the existence of a binding arbitration agreement between the parties.

On April 20, 1964, Judge Croake filed a further Opinion, printed in Appendix A hereto at page 23, in respect of the form of the Order to be entered.

On April 30, 1965, Judge Croake filed a Memorandum and Findings of Fact and Conclusions of Law, printed in Appendix A hereto at page 24, directing arbitration of the issues tendered by the diversity claims.

On March 10, 1966, the United States Court of Appeals for the Second Circuit, stating that the question was one of general importance in the securities field, rendered its Opinion, printed in Appendix A hereto at page 31, affirming in all respects, but for many different reasons, the determinations by the District Court.

Jurisdiction

Jurisdiction of this Court is invoked under 28 U.S.C. Section 1254.

Questions Presented

The only questions which will be argued in this Court if this Petition be granted are:

> Is there Federal question jurisdiction over a claim by a customer for damages arising by reason of a violation by a member of the New York Stock Exchange (the Exchange) of "just and equitable principles of trade" within the meaning of Section 6(b) [15 U.S.C. 78f(b)] of the Securities Exchange Act of 1934 (the Act) and Section 6 of Article XIV of the Constitution of the Exchange?

We shall urge that the negative determination of this question by the Court of Appeals is not only wrong but in essential conflict with its own important prior determination in *Baird* v. *Franklin*, 141 Fed. 2d 238 (2d Cir. 1944), cert. den. 323 U. S. 737.

A similar question arises in respect of violation by a member of the National Association of Securities Dealers, Inc. (NASD) of Section 15A(b)(7) [now 15A(b)(8)] of the Act [15 U.S.C. 78o-3(b)(8)] and Article I, Section 2(a) of the By-Laws and Article III of the Rules of Fair Practice of the NASD.

The above-mentioned statutes and provisions are printed in Appendix B hereto.

Section 6(b) of the Act provides, in substance, that no national securities exchange may be registered unless its rules "include provisions for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of the trade."

Section 15A(b)(8) of the Act contains a similar requirement in respect of the rules of a national association of securities dealers.

Section 27 of the Act [15 U.S.C. 78aa], printed at page 44, *infra*, confers exclusive jurisdiction on the United States District Courts over all civil actions arising under, or by reason of, violations of the Act.

In accordance with Section 6(b) of the Act, Section 6 of Article XIV of the Constitution of the Exchange (45, *infra*) provides that any member found guilty "of conduct or proceeding inconsistent with just and equitable principles of trade may be suspended or expelled as the Board may determine." Similar provisions are included in the By-Laws and the Rules of Fair Practice of the NASD (45-46, *infra*).

Statement

Seven of the claims set forth in the Complaint (3a, *et seq.*)* rest upon the above-mentioned Sections of the Act and the enactments of the Exchange and the NASD pursuant thereto. No question was raised as to the sufficiency of any one of said claims in the sense that it failed to state a cause of action cognizable in the proper court. Nor was there any claim or determination that the acts complained of do not constitute violations of just and equitable principles of trade. Respondent's attack, and the determinations by the Courts below, relate only to the existence of Federal question jurisdiction.

The dismissed claims (as do the sustained diversity claims) allege, in substance, that respondent is a stock broker and a member of the Exchange and the NASD; that petitioner was respondent's customer; that petitioner's accounts with the respondent contained securities having an aggregate value of about $26,000,000 against which petitioner owed respondent debit balances of about $18,000,000 so that petitioner's equity was about $8,000,000; that during the 19 business days following May 29, 1962, respondent, wrongfully sold approximately $10,000,000 of petitioner's securities (see Exhibit A annexed to Complaint, 17a-49a) in a manner and under circumstances constituting violations of just and equitable principles of trade.

Reasons for Granting the Writ

(a)

In the Court below petitioner stood largely upon the case of *Baird* v. *Franklin, supra,* decided by the same Court in 1944.

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* Parenthetical numerical references followed by "a" are to pages in the Joint Appendix in the Court of Appeals.

Baird was an action for damages against the Exchange on the theory that it had failed to comply with Section 6(b) of the Act and its own constitution in that it had failed to discipline Richard Whitney for conduct inconsistent with just and equitable principles of trade promptly after it had learned of Whitney's activities. The plaintiffs contended that, had the Exchange acted promptly, their losses would not have been suffered. The claim rested, and jurisdiction was asserted, squarely and solely upon the basis of Section 6(b) of the Act. No Judge of the Court of Appeals questioned jurisdiction. Judges Augustus N. Hand and Swan, speaking for the majority, held that there was no causal relationship between the failure of the Exchange to act when it learned the facts and plaintiffs' loss, saying (p. 239):

> "We can see no likelihood that the explusion or suspension of Richard Whitney when his conversions came to the notice of the officers of the Exchange on November 24, 1937, would have in the least benefited the plaintiffs for the securities were then all converted and in the hands of pledgees."

Judge Clark, in a dissenting opinion, disagreed with the majority on the question of the possible relationship between the failure of the Exchange to act promptly and plaintiffs' losses. He then undertook to discuss the questions of jurisdiction and implied liability which the majority assumed without discussion. Among other things, Judge Clark said:

> "Plaintiffs base their actions on two alternate and distinct theories. The first is that on or about November 24, 1937, the defendant New York Stock Exchange knew that Richard Whitney was guilty of unlawful acts and conduct inconsistent with just and equitable principles of trade, in that he had permitted his aggregate indebtedness to exceed a certain percentage of his net capital within the meaning of § 8(b) of

the Securities Exchange Act, 15 U.S.C.A. § 78(h) (b), had hypothecated, contrary to the provisions of § 8(c) and (d) of the Act, certain securities of the Gratuity Fund without consent of the trustees, and had used the mails to transmit false statements of the Gratuity Fund account in violation of § 10(b) of the Act, 15 U.S.C.A. § 78j(b); that from November 24, 1937, until on or about March 7, 1938, the defendant continously and willfully violated § 6(b) of the Act by failing to take action towards the expulsion, suspension, or discipline of Richard Whitney for his unlawful conduct; and that, since the Act was enacted for the benefit and protection of customers of members of registered exchanges and of such members of the general public, including plaintiffs, as might carry on security transactions with members of a registered exchange, plaintiffs were vested with a right of action by § 6(b) to recover from defendant the amount of their losses which resulted from the latter's violation of the Act. The second theory is that on the basis of the same facts recovery should be granted to plaintiffs as third-party beneficiaries of the agreement filed by defendant with the Securities and Exchange Commission pursuant to § 6(a) (1) of the Act." (p. 242)

* * *

"There can be no doubt that § 6(b) places a duty upon the Stock Exchange to enforce the rules and regulations prescribed by that section. Any other construction would render the provision meaningless. Defendant's argument that the Securities Exchange Act did not alter the prior status of the Stock Exchange Rules as by-laws of a private club is untenable. If all that § 6(b) meant was that every exchange should pass token regulations, incapable of enforcement except at the wish of the exchange itself, there would have been no purpose for its inclusion in the Act. Sections 6(b) and (d) were surely intended to be read together,

and the latter makes it clear that the purpose of the requirements of the former is 'to insure fair dealing and to protect investors.' This can be realized only if § 6(b) is construed as imposing the two-fold duty upon any exchange of enacting certain rules and regulations and of seeing that they are enforced." (p. 244)

"If Sec. 6(b) here were to be construed as granting no right of action to plaintiffs, the avowed purpose of 'reasonably complete and effective' protection would indeed be a snare and a delusion.

"The fact that the statute provides no machinery or procedure by which the individual right of action can proceed is immaterial. It is well established that members of a class for whose protection a statutory duty is created may sue for injuries resulting from its breach and that the common law will supply a remedy if the statute gives none. Texas & P. R. Co. v. Rigsby, 241 U. S. 33, 36 S. Ct. 482, 60 L. Ed. 874; Abounader v. Strohmeyer & Arpe Co, 243 N. Y. 458, 154 N. E. 309; Pine Grove Poultry Farm v. Newtown By-Products Mfg. Co., 248 N. Y. 293, 162 N. E. 84; Armour v. Wanamaker, 3 Cir. 202 F. 423." (p. 245)

That Judge Clark was speaking for the Court, and not as a dissenter from the majority opinion, in respect of the above-quoted statements, is certain. In *Brown* v. *Bullock,* 294 Fed. 2d 415 (2nd Cir. 1961), the same Court said that the majority in *Baird* had concurred with Judge Clark's view that Section 6(b) of the Act imposed a duty upon the Exchange to enforce it. In *Silver* v. *N.Y.S.E.,* 302 Fed. 2d 714 (2nd Cir. 1962), reversed 373 U. S. 341, the same Court quoted that portion of Judge Clark's opinion in *Baird* quoted above from page 244, and stated, in a footnote, that such language reflected the view of the Court. In *O'Neil* v. *Maytag,* 339 Fed. 2d 764 (2nd Cir. 1964), the same Court again reiterated that *Baird* stands

for the proposition that Section 6(b) of the Act will ground an action against an exchange in favor of a person damaged by failure of such exchange to enforce its rule relating to just and equitable principles of trade.

See also similar statements as to the holding in *Baird* in *Fratt* v. *Robinson,* 203 Fed. 2d 627 (9th Cir. 1953); *Hooper* v. *Mountain States Securities Corp.,* 282 Fed. 2d 195 (5th Cir. 1960); *Kroese* v. *N.Y.S.E.,* 227 Fed. Supp. 519 (S.D.N.Y. 1964), and *Pettit* v. *American Stock Exchange,* 217 Fed. Supp. 21 (S.D.N.Y. 1963), which last case also squarely upheld Federal jurisdiction under Section 6(b) of the Act in a suit against the American Stock Exchange. On the general principle of implied civil liability for violation of Federal Statutes, *Baird* has been cited in a number of other cases. For example, see *Dann* v. *Studebaker-Packard Corp.,* 288 Fed. 2d 201 (6th Cir. 1961) and *Subin* v. *Goldsmith,* 224 Fed. 2d 753 (2nd Cir. 1955).

(b)

Either the Court of Appeals was wrong in *Baird* or it is wrong in the instant case.

If Richard Whitney had been co-defendant with the Exchange in *Baird,* it might have been argued that there was no Federal jurisdiction over either defendant (i) because the violation was merely a violation of a provision of the constitution of the Exchange, enacted pursuant to the Act, but not a violation of the Act itself or (ii) because the nature of the Statute was such that Congress could not have intended civil liability to arise from its breach. Or it might have been contended that, while there might be Federal jurisdiction over Whitney because he violated the provision and the Statute, there could be no jurisdiction over the Exchange because it violated nothing but merely failed to police the provision in its constitution. But, we submit, it hardly could have been argued that there was Federal jurisdiction over the Exchange for failing to

police pursuant to such provision but not over Whitney for violating it. The distinction attempted by the Courts below is wholly illogical.

The Court of Appeals said (p. 35, *infra*) that "a Federal claim against the member firm existed in *Baird* since the misconduct charged was a violation of the statute itself." But *Baird* stands exclusively upon Section 6(b) of the Act and violations of "just and equitable principles of trade."

The Court of Appeals said (p. 36, *infra*) that whether jurisdiction could be predicated upon the violation of an Exchange rule was a "thorny" problem because of the multifarious subject matter of Exchange rules, and suggested that Federal question jurisdiction might arise from violation of some Exchange rules but not others. We agree. There are very many Exchange regulations, the violation of which clearly would not give rise to a Federal claim. See *Maytag, supra.* But the provision here involved was required by Congressional mandate and the Court of Appeals in *Baird* said that there was Federal question jurisdiction over a claim for damages for violation of it.

We agree with the Court of Appeals (p. 38, *infra*) that determination of questions of implication of civil liability for violation of Exchange rules cannot be determned on a "simplistic all or nothing basis." Nobody argued that they could. We repeat, however, that the provision herein involved was coerced by an Act of Congress and the Court of Appeals in *Baird* held that a claim for civil liability would be implied on behalf of one damaged by its violation.

The Court of Appeals said (pp. 38-39, *infra*) that the Statute and provision of the constitution of the Exchange constitute a "catch all" including "merely unethical behavior" and, therefore, "Congress could well not have intended to give rise to a civil claim." But the statute and

rule were the same when the same Court of Appeals decided, in *Baird*, that Congress did so intend. Surely it is no more difficult to determine what constitutes a violation of "just and equitable principles of trade" in an action by a customer against his broker than it is in an action by the same customer against an exchange.

Indeed, the Opinions by the Courts below make it clear that the true bases for their determinations were not the logic of the situation but fear that applying the rule of *Baird* to the instant case would open the door to increased litigation in the Federal Courts. But such cases have to be tried in *some* court. If *Baird* is correct, and its reasoning required implied liability for violaton of a statutory scheme enacted by Congress, why shouldn't such cases be tried in the Federal Courts where expertise in the subject matter is much greater than in the State Courts?

Perhaps this Court may find that *Baird* was incorrectly decided; that the fact that the provision in the Exchange constitution was enacted pursuant to Congressional mandate is not sufficient to give rise to implied civil liability for its breach. On the other hand, if it takes the case, this Court may hold that Congress intended to imply civil liability for breach of the provision required by the Statute in the same manner that civil liability has been implied for the breach of Sections 10(b) and 14(a) of the Act and numerous other Federal statutes and Rules of the Securities and Exchange Commission which contain no language in respect of civil liability. See *Borak* v. *J. I. Case Co.*, 377 U. S. 426 (1964). We shall, of course, so argue.

Certainly *Baird* and the instant case cannot be reconciled on the basis of any legal principle or reasoning. They are in essential conflict. Either violation of the Exchange provision and Statute gives rise to an implied claim on behalf of a member of the public damaged thereby against the violator and, upon proof of knowing

failure to act, against the Exchange, or there is no Federal claim against anyone. Yet, as we have seen, *Baird* has become a landmark case.

Whatever may be the result, we urge this Court to grant this application and promulgate a final determination of the question. As the Court of Appeals said (p. 34, *infra*) the question constitutes "an issue of general importance under the securities law."

Respectfully submitted,

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Of Counsel:

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April 18, 1966.

APPENDIX A

Opinions Below

Memorandum Opinion Dated March 19, 1964

(Record, pages 247 to 260)

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

[SAME TITLE]

CROAKE, District Judge

Pursuant to Rule 12(b)(1) and (6) of the Federal Rules of Civil Procedure, defendant moves for an order dismissing the complaint on the grounds: (a) it fails to state any federal claim upon which relief can be granted, and (b) there is no diversity of citizenship. In the alternative, defendant moves, pursuant to Sections 3 and 4 of the Federal Arbitration Act[1] and Section 7503 of New York Civil Practice Law and Rules, to compel arbitration and to stay this action pending arbitration.

Defendant is a limited partnership, organized under the laws of the State of New York,[2] a member of the New York Stock Exchange, and, of course, engaged in the stock brokerage business. It may be observed, parenthetically, that it is one of the better known stock brokerage houses in the United States. Plaintiff, a corporation organized under the laws of Delaware and having its principal place of business in Pennsylvania, was, at the time its alleged claims arose, a customer of defendant. Plaintiff seeks damages in the amount of $4,228,393, with interest and costs.

The essence of the complaint is that defendant sold securities in the margin account of plaintiff allegedly in

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[1] 9 U.S.C. 3 and 4.

[2] Sections 90-119, N. Y. Partnership Law.

violation of its agreement with plaintiff that it would not do so unless the equity of plaintiff in them fell below the margin requirements of the New York Stock Exchange. There are also related claims based upon alleged negligence in making the sales and additional claims for return of brokerage commissions.

The complaint contains sixteen separately stated claims. Claims "First" through "Sixth," "Thirteenth," and "Fifteenth," are common law claims, jurisdiction of which are not predicated upon any federal question. This court is alleged to have jurisdiction of these claims on the basis of diversity of citizenship.

The balance of the claims are factually based solely upon allegations set forth under the common law claims, but purport to be grounded upon Sections 6(b), 15A(b)(7), 27 and 29(b), of the Securities Exchange Act of 1934,[3] Article XIV of the Constitution of the New York Stock Exchange, Article I, Section 2(a) of the By-Laws of the New York Stock Exchange, and Article III, Section 1, of the Rules of Fair Practice of the National Association of Securities Dealers, Inc. (NASD).

I

It is the contention of defendant that the court lacks jurisdiction as to the common law claims because of the uncontroverted fact that a limited partner of defendant is a resident of Delaware.

Defendant relies on the case of *Great Southern Fireproof Hotel Co.* v. *Jones*, 177 U. S. 449 (1900). That case

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[3] 15 U.S.C. 78f(b), 78o-3(b)(7), 78aa, and 78cc(b), respectively. Reference to section "15A(a)(7)" in the complaint was evidently intended to be to § 15A(b)(7).

held that a limited partnership, organized under Pennsylvania law, could not plead that it, as an entity, was a citizen of any particular state for the purposes of diversity of citizenship jurisdiction. It further held that the fact that such limited partnership, under Pennsylvania law, was authorized to sue and be sued in its partnership name did not make the partnership equivalent to a corporation for such purposes.

Defendant further relies upon *Weinfeld* v. *Paine, Webber, Jackson and Curtis,* 191 F. Supp. 750 (D. Mass. 1961), which held that where the plaintiffs were citizens of Massachusetts and defendant was a limited partnership, nine of whose general partners and seven of whose limited partners were also citizens of Massachusetts, there was no diversity of citizenship jurisdiction. This case made no comment on whether the citizenship of the limited partners alone would have been controlling as to jurisdiction. Nor is *Eastern Metals Corp.* v. *Martin,* 191 F. Supp. 245 (S.D.N.Y. 1960), also cited by defendant, dispositive of this case as it involved an ordinary and not a limited partnership.

Plaintiff cites *Remington's Dairy* v. *Rutland Ry. Corp.*, 15 F.R.D. 488 (D. Vt. 1954),[4] for the proposition that, for diversity purposes, the citizenship of a partnership is determined by its principal place of business. That case was based upon *Darby* v. *Philadelphia Transportation Co.*, 73 F. Supp. 522 (E. D. Pa. 1947), which held, however, only that a partnership was a jural entity for the purposes of venue.

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[4] See also *Jacques Krijn En Zoon* v. *Schrijver*, 151 F. Supp. 955 (S.D.N.Y. 1957) citing this case with approval. But see *Joscar Company* v. *Consolidated Sun Ray, Inc.*, 212 F. Supp. 634 (E.D.N.Y. 1963), and *Feldmann Insurance Agency* v. *Brodsky*, 195 F. Supp. 433 (D. Md. 1961), *contra*.

In general, the Court of Appeals for this Circuit has held that a partnership is to be regarded as an aggregate rather than an entity for diversity purposes. See *Sperry Products* v. *Association of American Railroads,* 132 F. 2d 408 (2d Cir. 1942), *cert. denied* 319 U. S. 744 (1943) and *Levering & Garrigues Co.* v. *Morrin,* 61 F. 2d 115 (2d Cir. 1932), *aff'd on other grounds* 289 U. S. 103 (1933). Whether the line of cases cited by plaintiff for the contrary proposition represents a modern trend that eventually will become dominant, only the passage of time will reveal. Even assuming, however, the continuing validity of *Great Southern Fireproof Hotel Co.* v. *Jones,* 177 U. S. 449 (1900), *supra,* this court is nevertheless of the opinion that diversity of jurisdiction exists in this case. This conclusion rests upon the distinction between the roles of the general and the limited partner under the New York law. Under that law a limited partner, so long as he does not take part in control of the business, is not liable to creditors of the partnership[5] and is not "a proper party to proceedings by or against a partnership."[6] Moreover, it has been stated by the New York Court of Appeals that a limited partner has a status analogous to that of a corporate shareholder.[7]

It was long ago decided that the citizenship of a corporation for diversity purposes was to be determined without

[5] N. Y. Partnership Law, § 96.

[6] N. Y. Partnership Law, § 115. In this respect a New York limited partner is like a member of a Puerto Rican *sociedad en comandita* held to be an entity for jurisdictional purposes in *Puerto Rico* v. *Russell & Co.,* 288 U. S. 476 (1933). See page 481 of that opinion.

[7] *Ruzicka* v. *Rager,* 305 N. Y. 191, 197-8 (1953), *rearg. denied* 305 N. Y. 798 (1953).

regard to the actual citizenship of its stockholders. After a short series of decisions that would appear to be in conflict,[8] the Supreme Court finally settled upon the fiction that all stockholders of a corporation were conclusively presumed to be citizens of the state under whose laws the corporation was organized.[9] *Marshall* v. *The Baltimore and Ohio Railroad Co.*, 37 U. S. 314 (1853). In that case it was stated that the reason for the creation of the diversity of jurisdiction was to maintain the equality of citizens provided for in the "privileges and immunities" clause of the Constitution. It was reasoned that states, by permitting large numbers of people to combine in a corporation for the purpose of conducting a business, should not be permitted to vitiate the right of citizens to resort to the federal courts. The Court stated at page 326-7:

> "If A, B and C, with other dormant or secret partners, be empowered to act by their representatives, to sue or to be sued in a collective or corporate name,[10] their enjoyment of these privileges, granted by state authority, cannot nullify this important right [of a citizen to invoke the diversity jurisdiction] conferred on those who contract with them."

These considerations seem applicable to a New York limited partnership, at least so far as the limited partners

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[8] For a summary of these cases, see *Saint Louis & San Francisco Railway Company* v. *James*, 161 U. S. 545, 555 *et seq.* (1896).

[9] This doctrine has, to some extent, been modified by 28 U.S.C. 1332(c), enacted in 1958.

[10] New York permits suit by or against a partnership in partnership name. N. Y. CPLR § 1025. (Footnote added.)

are concerned. In an ordinary partnership, there is a practical limitation to the number of persons able to join in directing the enterprise and willing to risk unlimited liability. In a limited partnership, on the other hand, control can be vested in a relatively few general partners while capital can be supplied by a great number of individuals residing in many states without risking more than they invest.[11] A citizen of one of these potentially numerous states should not be deprived of the right to bring an action against the limited partnership in a United States District Court any more than a citizen of a particular state is precluded from so suing a corporation having a stockholder residing in the same state.

Defendant points out and plaintiff concedes that plaintiff should have alleged in the complaint the location of its principal place of business in view of the provisions of 28 U.S.C. 1332(c). It is undisputed that that place is in Pennsylvania and that defendant has no partner resident in that state. Accordingly, plaintiff will be permitted to amend its complaint to correct the omission.

In light of the fact that the court has found that there is jurisdiction based upon diversity of citizenship, there is no need to pass upon the contention of plaintiff that the court may entertain the common law claims under the doctrine of pendant jurisdiction.

II

The basis for the assertedly federal claims is that the conduct complained of was "not consistent with just and

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[11] The large real estate syndication, often organized as a limited partnership, is perhaps the best illustration of this kind of organization.

equitable principles of trade" within the meaning of Section 6(b) and 15A(b)(7) of the Exchange Act, Article XIV of the Constitution, and Article I, Sec. 2(a) of the By-Laws of the New York Stock Exchange, and Article III, Sec. 1 of the Rules of Fair Practice of the NASD. It is the position of plaintiff that the defendant, as a member of the New York Stock Exchange and the NASD, was subject to the aforesaid rules of those two bodies, and that because these rules were promulgated pursuant to Sections 6(b) and 15A of the Securities Exchange Act, allegations of conduct in breach thereof state causes of action cognizable under Section 27 of the Exchange Act.

Section 27 provides, in part, that the district courts "* * * shall have exclusive jurisdiction of violations of this title [the Securities Exchange Act] or the rules and regulations thereunder. * * *"

Sections 6(b) and 15A of the Act, however, do not explicitly impose duties upon brokers, but rather require securities exchanges and national securities associations registered under the Act, respectively, to promulgate rules requiring their members to abide by "fair and equitable principles of trade." Furthermore, the rules of the New York Stock Exchange and the NASD, which defendant is alleged to have violated, were not intended to be included within the phrase "rules and regulations" contained in Section 27. It is obvious that that phrase applies only to rules and regulations promulgated by the Securities and Exchange Commission and the Board of Governors of the Federal Reserve System. Section 23(a) of the Act[12] grants those two agencies power to promulgate "rules and regulations" whereas Sections 6(b) and 15A speak in terms of

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[12] 15 U.S.C. 78w(a).

"rules" or an exchange or association as distinct from "rules and regulations" promulgated by the Commission.

Plaintiff argues that despite the fact that there is no specific statutory authority for bringing a federal claim of the kind here asserted, it is, nevertheless, entitled to do so by virtue of the doctrine enunciated in *Bell* v. *Hood*, 327 U. S. 678 (1946) to the effect that there is a civil remedy where a federal law has been violated and a member of a class sought to be protected by such law has been injured. More specifically, plaintiff cites *Baird* v. *Franklin*, 141 F. 2d 238 (2d Cir. 1944), *cert. denied* 323 U. S. 737 (1944), which held that a registered securities exchange may be liable under Section 6(b) for failure to discipline one of its members.[18] That case, however, is inapplicable to the instant case in that liability of the Exchange was predicated upon the duty of supervision of its members directly imposed upon it by Section 6(b), whereas in the instant case liability is asserted as to a member of the Exchange, upon whom no direct duty is imposed by the Act.

For a number of reasons, this court is convinced that Congress did not intend, indirectly, to create a cause of action under the Exchange Act on behalf of a customer against his broker on account of transactions "not consistent with fair and equitable principles of trade." Almost any transaction with which a customer might not be satisfied, whether it violated state law or not, might be characterized as violating such principles. Furthermore, because the jurisdiction of the federal courts is exclusive under Section 27, the state courts would be

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[18] See also *Pettit* v. *American Stock Exchange*, 217 F. Supp. 21, 29-30 (S.D.N.Y. 1963).

ousted of jurisdiction of actions heretofore grounded upon state law alone, if the contentions of plaintiff were accepted. This court will not infer that Congress intended such drastic results without having explicitly so provided. Cf. *Howard* v. *Furst,* 140 F. Supp. 507, 513 (S.D.N.Y. 1956), *aff'd* 238 F. 2d 790 (2d Cir. 1956), *cert. denied* 353 U. S. 937 (1957).

Furthermore, the doctrine of *Bell* v. *Hood,* 327 U. S. 678 (1964), *supra,* is not without limitation. As stated in *Howard* v. *Furst,* 238 F. 2d 790 (2d Cir. 1956), at page 793, to be relied upon, a "federal right must be an essential element of plaintiff's claim" and "it must be of such a character that it will be supported if the federal law is given one construction or effect and defeated if it receives another."

As in the *Howard* case, the allegedly federal claims in the instant case are basically grounded upon New York law. The allegations in those claims, except for the averments that the actions taken by defendant were in violation of "fair and equitable principles of the trade," are merely reiterations of the common law claims. Those averments are no more than epithets applied to otherwise non-federal claims; or, again to use the words of the *Howard* case (p. 794), those averments "constitute a mere excrescence or superfluity, tacked onto what are otherwise sufficient allegations of a claim for relief under New York law."

Accordingly, this court holds that the claims "seventh" through "eleventh," "fourteenth," and "sixteenth" fail to state claims upon which relief can be granted. These claims are, therefore, dismissed.

III

Plaintiff raises two objections to the motion to stay this action and to compel arbitration: (1) arbitration is barred by Sections 27 and 29(a) of the Exchange Act,[12] and (2) it did not enter into an arbitration agreement with defendant.

As this court now holds that no federal claim has been pleaded under the Exchange Act, the first objection is invalid. With regard to the second objection, however, there appears to be a dispute of fact. Defendant has submitted a photocopy of a "Customers Margin Agreement" containing an arbitration clause and purportedly entered into on behalf of plaintiff by its secretary, Milton Selig. Mr. Selig, however, has submitted an affidavit stating that he entered into the agreement referred to for himself, personally, rather than for plaintiff corporation.

The agreement itself is not conclusive as to whether plaintiff is a party thereto and the court cannot resolve factual dispute on the submitted papers alone. Accordingly, a trial of the issue presented must be had pursuant to Section 4 of the Arbitration Act. See *L. L. Hoss Engineering & Transport Co.* v. *American Independent Oil Co.*, 289 F. 2d 346 (2d Cir. 1961), *cert. denied* 368 U. S. 837 (1961).

Settle order.

Dated: New York, N. Y.
March 19, 1964

THOMAS F. CROAKE
Thomas F. Croake
U. S. D. J.

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[12] See *Reader* v. *Hirsch & Co.*, 197 F. Supp. 111 (S.D.N.Y. 1961), which held that an agreement between broker and customer to arbitrate future disputes was unenforceable with respect to a cause of action founded upon the Exchange Act.

Memorandum Opinion on Form of Order Dated April 20, 1964

Colonial Realty Corporation v. *Bache & Co.* 63-Civ. 2240

Neither of the within proposed orders is in full compliance with the intent of the court and, accordingly, they are both returned unsigned to the Clerk of the Court. The Court has entered its own order without approval, at this time, of the application by plaintiff for leave to request permission for an interlocutory appeal therefrom pursuant to 28 U.S.C. 1292(b). Such leave has been denied in order to preclude the possibility of a multiplicity of appeals. However, after the issue of the making of the arbitration agreement has been determined, should either party be advised to make a similar application, the Court would be inclined to entertain it.

The application of § 1292(b) as contended by the parties is not now being determined.

Dated: New York, N. Y.
April 20, 1964

THOMAS F. CROAKE
Thomas F. Croake
U. S. D. J.

Memorandum and Findings of Fact and Conclusions of Law Dated April 30, 1965

(Record, pages 366 to 374)

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

[SAME TITLE]

CROAKE, District Judge

This is a motion by the defendant in the above-captioned action for an order dismissing the complaint or, in the alternative, for an order pursuant to Sections 3 and 4 of the Federal Arbitration Act and Section 7503 of the CPLR of the State of New York to compel arbitration and to stay this action pending such arbitration. By memorandum decision dated March 19, 1964 the undersigned denied the motion to dismiss the complaint and ordered a trial pursuant to Section 4 of the Federal Arbitration Act to determine whether or not the claim of the plaintiff is subject to arbitration.

The suit is for losses incurred on the sale of securities by defendant for the account of plaintiff, allegedly made in violation of a special margin agreement with defendant, and to recover certain brokerage fees. The claim is alleged to have arisen out of the maintenance by the plaintiff of a put and call account with the New York office of the defendant.

On December 4, 1964 a hearing was had at which the parties were afforded the opportunity to present testimony and documentary evidence. The specific issue to be determined by the court in this proceeding is whether or not the cause of action alleged by the plaintiff is subject to

the provisions of paragraph "16" of either of two written margin agreements allegedly executed by the parties. One of the agreements is undated but was purportedly received by the defendant on February 23, 1954 and the other bears the date of May 3, 1957. It is the contention of the plaintiff that neither of the aforesaid customer margin agreements affected the present controversy between the parties. Each of the written agreements bear the signature of Milton E. Selig, the secretary and treasurer of the plaintiff. If these agreements were executed on behalf of the plaintiff, then, on their face, the present controversy between the parties would come within their purview. Mr. Selig, however, denies that the agreements are applicable and by means of parole testimony has sought to demonstrate that the earlier margin agreement was made in connection with a personal account and the later margin agreement was applicable only to a special margin commodity account.

It is unnecessary to give a detailed summary and commentary on all of the evidence adduced by the parties. The court finds it incredible that Mr. Selig, an attorney and, apparently, sophisticated trader in securities, would after making an alleged special arrangement for margin requirements involving securities of a substantial value fail to have this agreement memorialized in some form of writing. The pitfalls of such a course of action are all too evident: the partner with whom he negotiated might have died or otherwise become unavailable. This consideration among others has induced the court to resolve the sharp issues of credibility raised in this proceeding against the plaintiff.

Memorandum and Findings of Fact and Conclusions of Law Dated April 30, 1965.

After considering the testimony and documentary evidence adduced at the hearing, the papers submitted, and arguments of counsel, the court renders the following findings of fact and conclusions of law:

FINDINGS OF FACT

1. The plaintiff is a Delaware corporation, having its principal office in Philadelphia, Pa.

2. Milton E. Selig is an attorney, admitted to practice in the State of Pennsylvania, and is the secretary, treasurer, and a director of the plaintiff corporation.

3. Milton E. Selig and his family are the principal stockholders of the plaintiff.

4. The defendant, a limited partnership, is organized under the laws of the State of New York.

5. The amount in controversy, as alleged in the complaint, exceeds $10,000, exclusive of interest and costs.

6. The defendant is engaged in the business of dealing in securities as a broker and otherwise. It is a member of the New York Stock Exchange, and other securities and commodities exchanges.

7. On February 2, 1954 a document entitled "Resolution Authorizing Account with Bache and Co." (defendant's Exhibit "C" herein) was executed by Milton E. Selig as secretary of the plaintiff and tendered by mail to the defendant.

8. The aforesaid "Resolution * * *" referred to in paragraph 7 herein authorized Milton E. Selig "* * * to

execute and deliver on behalf of * * * [the plaintiff] any customer's agreement required by Bache and Co.''.

9. Pursuant to the resolution described above, the said Milton E. Selig, on behalf of the plaintiff, executed a ''Customer's Margin Agreement'' with the defendant (defendant's Exhibit ''A'' herein) on or before February 23, 1954.

10. The said Customer's Margin Agreement in paragraph 16 thereof provides as follows:

> ''This agreement and its enforcement shall be governed by the laws of the State of New York. Any controversy between you and me arising out of, or relating to my account(s) with you, or to transactions with or for me, or to this contract, or the breach thereof, shall be settled by arbitration, in accordance with the rules, then obtaining, of either the Arbitration Committee of the Chamber of Commerce of the State of New York, or the American Arbitration Association, or the Board of Arbitration of the New York Stock Exchange, as I may elect. If I do not make such election by registered mail addressed to you at your main office within five (5) days after receipt of notification from you requesting such election, then you may make such election. Any arbitration hereunder shall be before at least three (3) arbitrators, and the award of the arbitrators, or a majority of them, shall be final, and judgment upon the award rendered may be entered in any Court, State or Federal, having jurisdiction. I agree that

notices of, and in, any such arbitration may be sent to me by mail, and waive personal service thereof."

11. That on May 23, 1957 another document entitled "Resolution Authorizing Account With Bache & Co." (defendant's Exhibit "E") was executed by Milton E. Selig as secretary of the plaintiff and tendered to the defendant.

12. The aforesaid resolution described in paragraph 11 hereof authorized Milton E. Selig, as secretary or treasurer of the plaintiff "* * * to execute and deliver on behalf of the * * * [plaintiff] any customer's agreement required by Bache and Co."

13. On May 3, 1957 Milton E. Selig on behalf of the plaintiff executed a "Customer's Margin Agreement" (defendant's Exhibit "F") required by the defendant which provided in paragraph 16 as follows:

"This agreement and its enforcement shall be governed by the laws of the State of New York. Any controversy between you and me arising out of, or relating to my account(s) with you, or to transactions with or for me, or to this contract, or the breach thereof, shall be settled by arbitration, in accordance with the rules, then obtaining, of either the Arbitration Committee of the Chamber of Commerce of the State of New York, or the American Arbitration Association, or the Board of Arbitration of the New York Stock Exchange, as I may elect. If I do not make such election by registered mail addressed to you at

your main office within five (5) days after receipt of notification from you requesting such election, then you may make such election. Any arbitration hereunder shall be before at least three (3) arbitrators, and the award of the arbitrators, or a majority of them, shall be final, and the judgment upon the award rendered may be entered in any Court, State or Federal, having jurisdiction. I agree that notices of, and in, any such arbitration may be sent to me by mail, and waive personal service thereof."

14. The court declines to adopt the testimony of Milton E. Selig that the "Customer's Margin Agreement" (defendant's Exhibit "A"), purportedly received on February 23, 1954 by the defendant, was executed in connection with a personal account of Mr. Selig and not on behalf of plaintiff.

15. The court declines to adopt the testimony of Milton E. Selig in so far as he alleges that defendant's Exhibit "A" did not contain on its back the name of the plaintiff at the time he signed the document.

16. The court declines to accept on the ground of credibility and materiality the testimony of Milton E. Selig in so far as he alleges that a representative of the defendant orally stated at the time he signed the "Customer's Margin Agreement" of May 3, 1957 that the scope of the agreement was limited to a special commodity account maintained by the plaintiff at the Philadelphia office of the defendant.

Memorandum and Findings of Fact and Conclusions of Law Dated April 30, 1965.

17. No evidence has been adduced to indicate that the aforesaid "Customer's Margin Agreement(s)" have been canceled or rescinded by plaintiff or defendant prior to the time that the cause of action of the plaintiff allegedly accrued.

18. The claim of the plaintiff relates to the maintenance by it of a margin account with the defendant.

CONCLUSIONS OF LAW

1. The court has jurisdiction over the parties and the subject matter of this action.

2. The controversy between the parties as set forth in the complaint herein is subject to arbitration pursuant to the terms of paragraph 16 of the "Customer's Margin Agreements," respectively described in paragraphs 10 and 13 of the Findings of Facts.

3. The controversy which is the subject matter of this action is subject to an arbitration agreement which is enforceable pursuant to Section 2 of the Federal Arbitration Act, 9 U.S.C. 2, and Section 7503 of the CPLR of the State of New York, and the defendant is entitled to a stay of this action pending such arbitration.

Settle order on notice.

Dated: New York, N. Y.
April 30, 1965

THOMAS F. CROAKE
Thomas F. Croake
U. S. D. J.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 144—September Term, 1965.

(Argued November 8, 1965 Decided March 10, 1966.)

Docket No. 29868

COLONIAL REALTY CORPORATION,

Plaintiff-Appellant,

—v.—

BACHE & Co.,

Defendant-Appellee.

Before:

LUMBARD, *Chief Judge,*
FRIENDLY and SMITH, *Circuit Judges.*

Appeal from an order in an action against a securities broker in the District Court of the United States for the Southern District of New York, Thomas F. Croake, *Judge,* which dismissed so much of the complaint as claimed violations of the Securities Exchange Act of 1934 and rules of the New York Stock Exchange and the National Association of Securities Dealers, and which stayed, pending arbitration, prosecution of the remaining claims in which federal jurisdiction was founded solely on diverse citizenship. Affirmed.

SPENCER PINKHAM (Colton & Pinkham, New York, N. Y.), *for Plaintiff-Appellant.*

MARVIN SCHWARTZ (Sullivan & Cromwell, New York, N. Y., Peter R. Fisher, of Counsel), *for Defendant-Appellee.*

FRIENDLY, *Circuit Judge*:

Colonial Realty Corporation, a Delaware corporation with its principal place of business in Pennsylvania, brought this action in the District Court for the Southern District of New York against Bache & Co., a limited partnership organized pursuant to the New York Partnership Law and engaged in securities brokerage in New York City. The controversy arises out of Bache's sales of securities in Colonial's margin account during the stock market dip of May and June 1962. Bache claimed it acted under authority of a clause in its standard form of margin contract in which Colonial covenanted to "maintain such margins as you may from time to time require, upon my accounts, and promptly meet all margin calls." Colonial relied on an alleged oral agreement that Bache would not require a margin in excess of the minimum requirements of the New York Stock Exchange and also claimed negligence on Bache's part. With respect to all securities sold to meet calls exceeding the Stock Exchange's minimum, Colonial sought to recover the losses it had suffered, running into millions of dollars, and some $100,000 in commissions which Bache had collected.[1]

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[1] Two claims were variations on the general theme. In one instance Colonial contended that because Bache misinformed it that its margin was below the Stock Exchange's minimum requirements, it sold certain securities to provide additional margin; it sought to recover the difference between the sales price of the securities and their highest intermediate value at a reasonable time thereafter. Another claim alleged an overcharge on debit balances.

The complaint predicated jurisdiction of the district court on both diversity and the existence of a federal question. Most of the claims were alleged to arise in the first instance from breach of contract or negligence, and in the second from Bache's failure to conduct its dealings in a manner "consistent with just and equitable principles of trade" within the meaning of §§ 6(b) and 15A(b)(7) of the Securities Exchange Act of 1934,[2] of Article XIV of the Constitution of the New York Stock Exchange (NYSE), and of Article I, § 2(a) of the By-Laws and Article III, § 1 of the Rules of Fair Practice of the National Association of Securities Dealers, Inc. (NASD). Bache moved for an order dismissing the complaint on the ground that it failed to state any federal claim and there was no diversity of citizenship, or, if that relief were denied, for an order compelling arbitration pursuant to its contract with Colonial and staying the action in the interim.

The district court dismissed the federal claims and, having found diversity, proceeded to hold a hearing to determine the applicability of the arbitration agreement.[3] After the hearing, the judge issued a second order staying the action pending arbitration under the Federal Arbitration Act, 9 U.S.C. § 4, and New York CPLR § 7503; this included a provision amending the prior order which had struck the federal claims so as to grant Colonial leave to request an interlocutory appeal pursuant to 28 U.S.C. § 1292(b). Although the stay of what would have been an

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[2] The latter section has subsequently been renumbered 15A(b)(8), 15 U. S. C. § 78o-3(b)(8).

[3] Having already dismissed the claims alleged to arise under federal law, the judge did not have to concern himself further with Colonial's point that arbitration was not available since its claims arose under the Securities Exchange Act. See *Wilko* v. *Swan*, 346 U. S. 427 (1953). The issue of fact on which the judge conducted the hearing is not pressed on appeal.

action at law was appealable under 28 U.S.C. §1292(a)(1), *Shanferoke Coal & Supply Corp.* v. *Westchester Service Corp.*, 293 U. S. 449 (1935); and Colonial's appeal therefrom necessarily involved the propriety of dismissal of the federal claims, see fn. 3, we granted leave under § 1292(b) to appeal from that ruling in order to eliminate any doubt as to our ability to reach an issue of general importance under the securities laws.

Colonial's assertion that the complaint alleged a violation of federally granted rights is based upon provisions in the Securities Exchange Act dealing with registration of exchanges and dealers' associations, and upon rules adopted pursuant to the statute by the NYSE and the NASD. Section 6(b) of the Securities Exchange Act provides:

> "No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation of any provisions of this chapter or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade."

Section 15A(b)(8) forbids registration of a national securities association unless:

> "the rules of the association are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges, and, in general, to protect investors and the public interest, . . ."

Under the NYSE Constitution, Art. XIV, § 6, disciplinary measures may be taken against a member found guilty "of conduct or proceeding inconsistent with just and equitable principles of trade"; the NASD By-Laws, Art. I, § 2(a), and Rules of Fair Practice, Art. III, § 1, prohibit membership by persons disciplined on this account and require members to "observe high standards of commercial honor and just and equitable principles of trade." The complaint alleged simply that Bache's dealings were not consistent with such principles without elaborating how, save insofar as this can be gleaned from the charges of breach of contract and of failure to use due care to protect its customer's interests.

Colonial relies largely on *Baird* v. *Franklin*, 141 F. 2d 238 (2 Cir.), cert. denied, 323 U. S. 737 (1944), in which this court recognized that culpable failure by a stock exchange to enforce rules adopted pursuant to § 6(b) of the Securities Exchange Act may give rise to a federal claim against the exchange by an investor injured thereby. See *Brown* v. *Bullock*, 294 F. 2d 415, 421 (2 Cir. 1961); *Silver* v. *New York Stock Exchange*, 302 F. 2d 714, 719 (2 Cir. 1962), rev'd on other grounds, 373 U. S. 341 (1963). Colonial urges that the civil liability thus implied from § 6(b) cannot reasonably be limited to an exchange but must extend to a member firm whose conduct has violated rules adopted by the exchange under the statute; it says that the delinquent broker in the *Baird* case would also have had to be held for an implied federal liability. Although we agree that a federal claim against the member firm existed in *Baird* since the misconduct charged was a violation of the statute itself, see 141 F. 2d at 242, this does not establish that implication of a private right of action against an exchange for culpable failure to enforce its rules necessarily calls for recognizing a similar right

against an individual broker who is claimed to have violated them.

We start from the proposition that the judicial recognition and enforcement of a private remedy not expressly afforded by the Securities Exchange Act is predicated on the duty of the courts "to make effective the congressional purpose" represented in "the statute and the federal policy which it has adopted." *J. I. Case Co.* v. *Borak*, 377 U. S. 426, 433 (1964). Implication of a private right of action may be suggested by explicit statutory condemnation of certain conduct and a general grant of jurisdiction to enforce liabilities created by the statute, as in cases under §§ 10 and 14 of the Act, see *Fischman* v. *Raytheon Mfg. Co.*, 188 F. 2d 783 (2 Cir. 1951); *J. I. Case Co.* v. *Borak, supra*, or from such considerations as the protection intended by the legislature and the ineffectiveness of existing remedies, administrative and judicial, fully to achieve that end. See *Baird* v. *Franklin, supra*, 141 F. 2d at 244-45; 2 Loss, Securities Regulation 945 (1961). Whether such a claim can be maintained for violation of stock exchange rules is a thorny problem because the effect and significance of particular rules may vary with the manner of their adoption and their relationship to provisions and purposes of the statute and SEC regulations thereunder; the difficulty lies in the scope of the unique statutory scheme of "supervised self-regulation" by exchanges and dealers' associations. See SEC, Report of Special Study of Securities Markets, H. R. Doc. No. 95, 88th Cong. 1st Sess., Pt. I, 3-4; Pt. 4, 692-728 (1963).

As to matters not covered by the statute or Commission regulations, the exchanges are given a wide range of discretion in establishing standards and principles that should govern trading of securities on the auction market; the

mandate of § 6(b) that rules insure observance of "just and equitable principles of trade" could hardly be broader, the only specific requirement being that wilful violation of the statute be condemned. See *Silver* v. *New York Stock Exchange,* 373 U. S. 341, 352 (1963). That Congress did not intend violations of all rules adopted under § 6(b) to give rise to civil claims under federal law is somewhat indicated by the explicit reliance in the section on the disciplinary function of the exchanges to provide protection for the investing public, see *Silver* v. *New York Stock Exchange, supra* at 371 (dissenting opinion). Basis for an even broader negation can arguably be found in the absence of any reference to exchange rules in the grant of federal jurisdiction over "all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder," Securities Exchange Act § 27, in contrast to the explicit reference to exchange rules in § 29(a)—although acceptance of this argument would not foreclose a contention that there might still be a federal claim of which district courts would have concurrent jurisdiction under 28 U. S. C. §§ 1331 or 1337. Compare *T. B. Harms Co.* v. *Eliscu,* 339 F. 2d 823, 828 (2 Cir.), cert. denied, 381 U. S. 915 (1965). In *O'Neill* v. *Maytag,* 339 F. 2d 764, 770 (2 Cir. 1964), in repudiating a belated attempt to rest federal jurisdiction on a listing agreement between a corporation and the NYSE, this court refused to give general recognition to private rights of action for alleged violations of stock exchange rules.

On the other hand, we cannot ignore that the concept of supervised self-regulation is broad enough to encompass a rule which provides what amounts to a substitute for regulation by the SEC itself. Not content with insisting

upon Commission approval of exchange rules as a prerequisite to registration under §§ 6 and 15A, Congress authorized the agency to request modification of particular rules or to promulgate superseding regulations on its own, § 19. A particular stock exchange rule could thus play an integral part in SEC regulation notwithstanding the Commission's decision to take a back-seat role in its promulgation and enforcement, and we would not wish to say that such a rule could not provide the basis for implying a private right of action.[4]

What emerges is that whether the courts are to imply federal civil liability for violation of exchange or dealer association rules by a member cannot be determined on the simplistic all-or-nothing basis urged by the two parties; rather the court must look to the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation. The case for implication would be strongest when the rule imposes an explicit duty unknown to the common law. The rules here at issue, however, are near the opposite pole. Although they do impose a duty upon members not to engage in conduct inconsistent with fair and equitable principles of trade, which the exchange or association can enforce through disciplinary proceedings, they are something of a catch-all which, in addition to satisfying the letter of the

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[4] An example of this type of rule is NYSE Rule 452, which prohibits, in certain cases, a member from voting stock held in a street name without specific instructions from the beneficial owner. See Lowenfels, Implied Liabilities Based Upon Stock Exchange Rules, 66 Colum. L. Rev. 12, 25-28 (1966). The author points out that, doubtless because of the exchange rules, the SEC terminated a rule-making proceeding of its own. See Securities Exchange Act Releases 5166, 20 F. R. 3233 (1955), 5299, 21 F. R. 2636 (1956), 6901, 27 F. R. 9844 (1962).

statute, preserves power to discipline members for a wide variety of misconduct, including merely unethical behavior which Congress could well not have intended to give rise to a legal claim. We find little reason to believe that by requiring exchanges and dealers' associations to include such provisions in their rules Congress meant to impose a new legal standard on members different from that long recognized by state law. See Note, Implying Civil Remedies From Federal Regulatory Statutes, 77 Harv. L. Rev. 285, 292 (1963).

The consequences of the view urged by Colonial would be so disruptive as to require much more impressive evidence of congressional purpose than we can discern. For example, as illustrated by this very case, the widely adopted practice of resorting to arbitration as a means of settling controversies between stockbrokers and their customers would be outlawed whenever the customer chose to rely not on breaches of contract or negligence *simpliciter* but on the more sophisticated theory that the broker's acts were "inconsistent with just and equitable principles of trade," see *Wilko* v. *Swan*, 346 U. S. 427 (1953); at least this would be so, if the rule of *Wilco*, decided under the Securities Act of 1933, is applicable also under the Securities Exchange Act of 1934.[5] Moreover, mere recitation of the statutory watchword by an aggrieved investor would saddle the federal courts with garden-variety customer-broker suits, even though the controversy was between citizens of the same state, the sum in question did not attain the jurisdictional amount required by 28 U. S. C. § 1331, and there was no indication that the case would be decided

[5] Distinction would seem unlikely since § 14 of the 1933 Act, on which the Court relied in *Wilko*, has an almost identical counterpart in § 29(a) of the 1934 Act, which, indeed, specifically refers to "any rule of an exchange."

differently under state law—unless we were to make the large assumption that by requiring adoption of rules embodying this phrase Congress meant the federal courts to develop a new body of broker-customer law. Indeed, if § 27 were read to include exchange rules, the jurisdiction of the federal courts would be exclusive, and the state courts would be altogether stripped of power to adjudicate claims so pleaded even between their own citizens. See Loss, Securities Regulation, 996-99, 2005-06 (1961).[6]

Since we thus affirm the decision that the complaint did not state a claim under federal law, we are confronted with Bache's contention that the remaining counts should have been dismissed for lack of diverse citizenship. We may, indeed we must, consider such a challenge to the jurisdiction of the district court, *Mitchell* v. *Maurer*, 293 U. S. 237, 244 (1934), even though Bache did not seek leave to appeal from denial of its motion to dismiss.

The argument is that a limited partner of Bache & Co. is a citizen of Delaware and that diversity is thereby destroyed under the venerable doctrine of *Strawbridge* v. *Curtiss*, 3 Cranch 267 (1806). The district judge recognized that the citizenship of a limited partnership was not sufficiently made out for diversity purposes by alleging the

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[6] It is true that the implication of a civil claim for violation of § 10 of the Securities Exchange Act and Rule 10b-5 issued thereunder, see *Fischman* v. *Raytheon Mfg. Co.*, 188 F. 2d 783 (2 Cir. 1951), can create similar problems of displacing arbitration and indiscriminately extending federal jurisdiction into preserves traditionally occupied by the states. This interstitial judicial law-making has not escaped criticism. See Ruder, Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?, 57 Nw. U. L. Rev. 627 (1963). But there Congress has placed a moderately specific prohibition directly on the defendant and, even though the prohibition in considerable measure tracks the common law, there is more basis for finding a congressional direction for the creation of a specifically federal law than in the case of a broker's alleged violation of a stock exchange commandment vaguely adjuring him to behave himself. Our decision in *Brown* v. *Bullock*, 294 F. 2d 415, 421 (2 Cir. 1961), is fairly distinguished on similar grounds.

state of its organization, even though state law permitted the partnership to sue or be sued in the firm name. *Great Southern Fire Proof Hotel Co.* v. *Jones,* 177 U. S. 449 (1900). But he correctly held that where, as here, there was diversity between the plaintiff and all the general partners of the defendant, identity of citizenship between the plaintiff and a limited partner was not fatal because under the applicable New York statute a limited partner "is not a proper party to proceedings by or against a partnership, except where the object is to enforce a limited partner's right against or liability to the partnership." N. Y. Partnership Law § 115. In the absence of a claim of insolvency of the partnership, see *Klebanow* v. *New York Produce Exchange,* 344 F. 2d 294, 298 (2 Cir. 1965);[7] *Fuhrmann* v. *Von Pustau,* 126 App. Div. 629, 111 N. Y. Supp. 34 (1st Dept. 1908), a suit brought against a New York partnership must thus be considered to be against the general partners only and identity of citizenship between a limited partner and the plaintiff does not destroy diversity.

The judgment is in all respects affirmed.

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[7] Although the Appellate Division for the First Department, in a 3-2 decision, has declined to validate our prediction in *Klebanow* that New York would allow a limited partner, on a proper showing, to maintain a derivative action, *Millard* v. *Newmark & Co.,* —— App. Div. 2d ——, 266 N. Y. S. 2d 254 (1966), that decision in no way affects the point here made; indeed it would serve to strenghten it.

Statutes

Securities Exchange Act of 1934:

Sec. 6(b) [15 U.S.C. 78f(b)]:

"SEC. 6. (a) Any exchange may be registered with the Commission as a national securities exchange under the terms and conditions hereinafter provided in this section, by filing a registration statement in such form as the Commission may prescribe, containing the agreements, setting forth the information, and accompanied by the documents, below specified:

* * * * *

"(b) No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation of any provisions of this title or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade."

Sec. 15A (b)(8) [15 U.S.C. 78o-3(b)(8)]:

"(b) An applicant association shall not be registered as a national securities association unless it appears to the Commission that—

* * * * *

"(8) the rules of the association are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges, and, in general, to protect investors and the public interest, and to remove impediments to and perfect the mechanism of a free and open market; and are

not designed to permit unfair discrimination between customers, or issuers, or brokers or dealers, to fix minimum profits, to impose any schedule of prices, or to impose any schedule or fix minimum rates of commissions, allowances, discounts, or other charges."

See. 27 [15 U.S.C. 78aa]:

"The district courts of the United States, the District Court of the United States for the District of Columbia, and the United States court of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this title or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this title or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this title or rules and regulations thereunder, or to enjoin any violation of such title or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be the subject to review as provided in sections 128 and 240 of the Judicial Code, as amended (U.S.C., title 28, secs. 225 and 347). No costs shall be assessed for or against the Commission in any proceeding under this title brought by or against it in the Supreme Court or such other courts."

New York Stock Exchange

Constitution

ARTICLE XIV

Expulsion and Suspension from Membership or from Allied Membership—Disciplinary Proceedings

Violation of Constitution, Rules or Resolutions—Inequitable Conduct

SEC. 6. A member or allied member who shall be adjudged guilty, by the affirmative vote of a majority of the Governors then in office, of a violation of the Constitution of the Exchange or of a violation of a rule adopted pursuant to the Constitution or of a violation of a resolution of the Board of Governors regulating the conduct or business of members or allied members or of conduct or proceeding inconsistent with just and equitable principles of trade may be suspended or expelled as the Board may determine.

National Association of Securities Dealers, Inc.

By-Laws, Article I

"SECTION 2(a) No broker or dealer, except with the approval or at the direction of the Securities and Exchange Commission (hereinafter referred to as the Commission), in cases in which the Commission finds it appropriate in the public interest so to approve or direct pursuant to Section 15A of the Securities Exchange Act of 1934, as amended (hereinafter referred to as the Act), shall be admitted to or continued in membership in the Corporation if (1) such broker or dealer, whether prior or subsequent to becoming such or (2) any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), or any person directly or indirectly controlling or controlled by such broker or dealer, whether prior or subsequent to becoming such (A) has been and is suspended or

expelled from a securities association (whether national or affiliated) registered pursuant to Section 15A of the Act, or from a national securities exchange, registered pursuant to Section 6 of the Act, for violation of any rule of such association or exchange which prohibits any act or transaction constituting conduct inconsistent with just and equitable principles of trade, or requires any act the omission of which constitutes conduct inconsistent with just and equitable principles of trade, or (B) is subject to an order of the Commission denying or revoking his registration pursuant to Section 15 of the Act, or expelling or suspending him from membership in a registered securities association or a national securities exchange, or (C) by his conduct while employed by, acting for, or directly or indirectly controlling or controlled by, a broker or dealer, was a cause of any suspension, expulsion, or order of the character described in Clauses (A) or (B), which is in effect with respect to such broker or dealer, or (D) has been and is subject to an order of a registered securities association or national securities exchange, which order cancels, terminates, revokes or suspends the registration of such person as a registered representative or employee for conduct contrary to high standards of commercial honor or just and equitable principles of trade, or (E) has been convicted within the preceding ten years of a felony or misdemeanor involving the purchase or sale of any security or arising out of the conduct of the business of a broker or dealer, or (F) has been convicted within the preceding ten years of any felony or misdemeanor which the Association finds involved embezzlement, fraudulent conversion, misappropriation of funds or a use or misuse of a fiduciary relationship."

Rules of Fair Practice, Article III

"SECTION 1 A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No. ~~1322~~ 142

COLONIAL REALTY CORPORATION,
Petitioner,

against

BACHE & CO.,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

RESPONDENT'S BRIEF IN OPPOSITION

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June 8, 1966

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No. 1322

COLONIAL REALTY CORPORATION,

Petitioner,

against

BACHE & CO.,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

RESPONDENT'S BRIEF IN OPPOSITION

Statement of the Case

The claim which is said to be so exclusively federal as to bar arbitration or adjudication in the state courts is that respondent Bache & Co., during the stock market crisis of May 1962, sold out $10 million of securities when petitioner Colonial Realty Corporation failed to meet margin calls. Colonial alleges that its securities were negligently and carelessly "dumped" (JA 8-9)* and that Bache's margin calls and charges for interest breached an oral agreement made when the account was opened (JA 4-5, 13).

Colonial is a closely-held family corporation controlled by one Selig, a lawyer (SA 1).* The precise nature of

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* References to the Joint Appendix below are indicated as "JA". References to the Supplementary Appendix below are indicated as "SA".

Colonial's claim appears not only from its complaint, but also from testimony given by Selig at a trial in the District Court on the issue whether he had entered into, on Colonial's behalf, an agreement to arbitrate all controversies with Bache (SA 1-4).

Colonial's account at Bache was devoted primarily to trading in "options"—puts, calls, straddles and the like (SA 3). At the time the margin calls were made and the securities sold out, Colonial held on margin in its account at Bache securities of the value of more than $30 million (SA 2).

Selig claimed that when he opened Colonial's account with Bache in 1954, he made an oral agreement with a Bache partner that Colonial would not be required to maintain margins in excess of the 25% minimum margin requirement of the New York Stock Exchange (SA 3) and that the interest rate on money borrowed from Bache would be one-half of one percent above the minimum rate at which Bache itself could borrow (SA 4).

However, Selig signed on Colonial's behalf when he opened the account an agreement (JA 57) which provided for the arbitration of "[a]ny controversy between you [Bache] and me arising out of, or relating to my account(s) with you or to transactions with or for me or to this contract, or the breach thereof" (par. 16). The agreement provided also that Colonial would "maintain such margins as you [Bache] may from time to time require" (par. 3) and that the written agreement containing these and other provisions could not be changed or modified except in writing (par. 7).

Selig contended in the District Court that he did not execute this agreement on behalf of Colonial, but rather in connection with a personal account (JA 83-84).

The District Court rejected Selig's testimony "on the ground of credibility" (JA 118) and stayed the action pending the arbitration to which Colonial had previously agreed (JA 120).

In an effort to avoid its obligation to arbitrate, Colonial alleged in its complaint in the District Court that Bache's demands for additional margin and the "careless" manner in which the securities were liquidated were violations of the Securities Exchange Act of 1934. The Act was violated, Colonial alleged, because this was conduct on Bache's part which was "not consistent with just and equitable principles of trade" (JA 10-12, 14-16) and because national securities exchanges and associations of securities dealers are required by sections 6(b) and 15A(b)(7)* of the Exchange Act, 15 U.S.C. §§78f(b), 78*o*—3(b)(7), to have rules providing for the disciplining of members for "conduct inconsistent with just and equitable principles of trade" in order to be registered under the Act.

Bache is a member of the New York Stock Exchange, a national securities exchange registered with the Securities and Exchange Commission under the Exchange Act, and of the National Association of Securities Dealers, an association of securities dealers likewise registered under the Act, as a national securities association.

Implicit in Colonial's theory of its case is the assumption, predicated upon *Wilko* v. *Swan*, 346 U. S. 427 (1953), that a litigant cannot be compelled to arbitrate a claim cognizable under the Exchange Act.

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* Now renumbered section 15A(b)(8), 15 U.S.C. §78*o*—3(b)(8) as the result of 1964 amendments, 78 Stat. 565.

Reasons for Denial of the Writ

I.

The alleged conflict with *Baird* v. *Franklin*, 141 F. 2d 238 (2d Cir.), *cert. denied*, 323 U. S. 737 (1944), a prior decision of the same court to which certiorari is now sought, is not a ground for allowance of the writ. No conflict is claimed with any decision of any other circuit. In any event, the decisions below are fully consistent with *Baird* v. *Franklin*, where plaintiffs sued the New York Stock Exchange for *its* failure to enforce rules which the Act required it to adopt and enforce. The court indicated only that the *Exchange* was liable under the Securities Exchange Act to customers of a member firm if the *Exchange's* failure caused the customers' loss. The case does not suggest even remotely that a *member's* violation of an exchange or NASD rule creates a federal right of action against that member.

II.

The courts below were clearly correct in rejecting petitioner's ingenious theory of exclusive federal jurisdiction under the Securities Exchange Act. It is difficult to see how the Court of Appeals and the District Court could have decided otherwise, for ingenuity alone cannot bestow sufficient merit upon petitioner's contentions to warrant their classification as "important".

We know of no statute in this country which has been construed to require a court, as distinguished from an administrative agency or quasi-public body, to determine legal responsibility in the first instance according to a standard comparable to "just and equitable principles of trade". Petitioner's theory of the Act would require the federal courts to adjudicate controversies according to

standards which have no roots in legal history or in legal precedent. As Judge Friendly concluded below (Pet. 39), had Congress intended an innovation so sweeping, the legislative history of the Exchange Act would surely bear witness to that intention; and it does not.

The congressional committee reports and the Act itself confirm instead that the whole purpose of sections 6(b) and 15A was to encourage self-regulation by the already-existing exchanges and by the over-the-counter associations which it was hoped would be organized. See H. R. REP. No. 1383, 73rd Cong., 2d Sess. 15 (1934); S. REP. No. 792, 73d Cong., 2d Sess. 13 (1934) (both discussing §6(b)); S. REP. No. 1455, 75th Cong., 3d Sess. 3-4 (1938) (discussing §15A). See also *Avery* v. *Moffatt*, 187 Misc. 576, 592, 55 N.Y.S.2d 215, 227-228 (N. Y. Sup. Ct. 1945); *Silver* v. *New York Stock Exchange*, 373 U. S. 341, 353-54 (1963); 2 LOSS, SECURITIES REGULATION 1175-1176, 1374 at n. 66 (2d ed. 1961); and SEC, *Report of Special Study of Securities Markets*, H. R. Doc. No. 95, 88th Cong., 1st Sess. pt. 1, at 3-4 (1963).

As to the statutory language, section 6(b) conditions registration of a stock exchange upon the adoption of rules providing for the "expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade". Section 15A(b)(7) conditions registration of an association of securities dealers upon the adoption of rules "to promote just and equitable principles of trade".

The phrase "just and equitable principles of trade" was included in sections 6(b) and 15A(b)(7) because it had long appeared in the rules of stock exchanges in this country and was "probably universally understood to cover the dealings of members with each other". *National Association of Securities Dealers, Inc.*, 19 S.E.C. 424, 484 (1945) (dissenting opinion of Commissioner Healy).

The statute thus does not stamp as unlawful conduct which is "unfair" or "inequitable", nor does it require the courts to fix legal responsibility upon a standard so ephemeral. Indeed, if the Act proscribed such conduct by a securities dealer it would impose an astoundingly unique standard of criminal responsibility, for each and every wilful violation of the Act is punishable by fine or imprisonment under section 32(a), 15 U.S.C. §78ff(a).

Sections 6(b) and 15A(b)(7) of the Exchange Act thus confirm a standard of business ethics which is to be applied by the exchanges and by the NASD in regulating the conduct of their members. That standard has no application to controversies in a court of law between stockbrokers and their customers, for if it did, any customer could invoke exclusive federal jurisdiction and seek to preclude the traditional remedy of arbitration by adding to its complaint the talismanic accusation that the broker acted in a manner "inconsistent with just and equitable principles of trade".

CONCLUSION

The petition for certiorari should be denied.

Respectfully submitted,

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Dated: June 8, 1966.